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SUBJECT: ESTONIA: INVESTMENT TRENDS & CHALLENGES

11. (U) SUMMARY. The Estonian economy is strong, and a favorable and open destination for foreign investment. Nevertheless, a labor crunch, infrastructure strain, and some uncertainties in the business climate pose possible future threats to growth. Ideas for attracting future FDI include positioning the country for a greater role as a transit hub between the EU, Russia and China and increasing the focus on tourism, services, higher value-added industries, and exports, rather than the import of components and raw materials for processing here. However, the GOE does not appear to have a concerted, long-term plan to realize these goals. End summary.

STRONG ECONOMY, WITH SOME WARNING SIGNS

12. (U) Foreign direct investment (FDI) into Estonia has remained steady at roughly EUR 500 million (USD 635 million) per year for the past ten years. The share of FDI comprised of reinvested profits has been growing steadily; it is currently almost equal to the level of new investment capital. The overwhelming majority of FDI (79%) continues to flow into Tallinn. The financial sector (47%), real estate (14%) and manufacturing (13%) make up the three largest activities into which FDI is flowing.

13. (U) Real GDP growth in 2005 was a strong 10.5% and accelerated further in the first quarter of 2006. There are some factors, however, which could erode the positive investment climate in Estonia if not addressed quickly by the GOE. One complaint frequently echoed by the hotel industry, manufacturing firms, and even IT companies is the shortage of labor. U.S. companies currently invested in consistently complain they would be hard pressed to expand operations here due to the tight labor market and associated rising wages and employee turnover. Furthermore, they find it difficult to find enough qualified Estonians with technical and engineering skills; not only is the Estonian educational system not producing enough of the right kind of graduates, but some are using their degrees to work abroad. According to a recent labor market study by the Estonian Central Bank, an estimated 17,000 Estonians have moved abroad since EU accession. Primary destinations are Finland, the UK, Ireland, and Sweden. Another roughly 15,000 left to work in Finland during 2002-03 before Estonia joined the EU. (Comment: With a full-time workforce of just over 500,000, the departure of even 30,000 workers over four years - many of whom are semi- or highly skilled - has clearly been felt. It is not clear how many of these may have ultimately returned to Estonia. End comment.)

14. (U) The GOE was initially reluctant to acknowledge a

labor shortage, in part because for many years unemployment was the primary labor concern. (Note: Unemployment did not fall below 10% until 2004, and still remains higher than the national average for non-Estonian youth and the largely Russian-speaking northeast. End note.) As recently as last year, the Minister of Economic Affairs and Communication, Edgar Savisaar, said "I don't see a labor shortage in Estonia. Some companies have complained they cannot find workers and I just say they are not advertising in the right places..." While the problem is acknowledged today, there is still a reluctance to increase levels of immigration by foreign workers to Estonian given Estonia's unpleasant history with migrant workers during the Soviet period.

#### TAXES, INFRASTRUCTURE AND OTHER ISSUES

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15. (U) Uncertainty in regards to future investment in Estonia does not only stem from the tight labor market. A lack of clarity on the future of the tax code, and the GOE's perceived lack of responsiveness to firms creates some uncertainty in the business climate as well. To come into compliance with conditions of EU accession, the GOE is obligated to raise its rate of taxation on corporate profits reinvested domestically above the current rate of zero by 2009. While the GOE is actively considering alternatives, it is still not clear when or how high they would raise this tax rate.

16. (U) Estonia has made great strides in upgrading its Soviet-era infrastructure to meet the needs of a modern economy, in some cases leap-frogging over several generations of technology to implement state-of-the art practices, as they have done in the banking sector. Tallinn continues to experience a real estate boom, and major road, rail, bridge, and port development projects are underway. The private port at Sillamae opened in October 2005, and the U.S. Trade Development Agency is paying for a feasibility study for upgrades to the Port of Tallinn.

17. (U) Two key projects, however, are moving forward more slowly. Business leaders, Enterprise Estonia and the Ministry of Economy identify an expansion to four lanes of the highway connecting Tallinn and Tartu, and a modernized railway bridge at Narva on the Russian border as important for future growth. However, the road expansion could take 10-20 years due to regulatory and technical issues, and the bridge must be negotiated with counterparts on the Russian side.

18. (U) Andrus Viirg, Director of Foreign Investments and Trade Promotion for Enterprise Estonia acknowledged what we have heard from the AmCham: that the GOE has been somewhat less "attentive" in recent years to the needs of businesses already operating in Estonia than it was in the late 1990s. This is in part due to an administrative re-organization to bring the formerly separate boards of tourism, business development, export promotion, FDI, and technology under one umbrella at Enterprise Estonia. A second reason is that the GOE's attention is absorbed in the process of using EEK 5.8 billion (USD \$476 million) in EU Structural Funds during 2004-06 according to the National Development Plan. To date, 30% of these funds have been implemented. (Note: EU funds may also have a crowding-out effect on private capital that would otherwise compete for development projects. End note.)

#### ATTRACTING THE NEXT WAVE OF FDI

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19. (U) All of the parties we spoke to are focused on new strategies for attracting additional FDI to Estonia now that the initial wave of privatizations is over and the economy is maturing. One of the most common ideas we have heard was to capitalize on Estonia's position as a geographic crossroads. The country is an attractive, stable platform from which investors can operate in Russia,

without the risks of being physically located there. Further, it is a potential logistics hub and transit point for rail and shipping between East and West, specifically for Chinese manufacturers shipping goods to the EU. A large delegation led by the head of the Chinese Parliament's advisory body visited Estonia in late October to explore just such opportunities. According to press reports, they discussed economic ties (including oil shale processing with Chinese cooperation for energy and chemical industry use), opportunities for transit, and cultural cooperation. (Comment: While the recent Chinese delegation is an interesting development, the idea of Estonia capitalizing on its proximity to other large markets, namely Russia, has been around for some time. It is not clear, however, that the GOE has any coordinated, long-term strategy for advancing this idea to bring in FDI. End comment.)

¶10. (U) Estonians are certainly active in building business ties abroad, especially to the east. People we spoke to within the GOE and in the private sector echo what the manager of Balti Spoon (a U.S. company and the world's largest manufacturer of wood veneer for use by Ikea and others) said at a recent symposium on doing business with Russia: "Estonians and Russians are quite similar in their business culture due to the shared Soviet background, so they easily find a common language. When it comes down to people-to-people relationships, the political fog disappears..." However, this advantage may not last. A director of the majority U.S. owned Estonian Railway noted that this level of Russia fluency - a key advantage for Estonians in attracting investment away from their Scandinavian competitors - applies only to Estonians 25 years and older. "The younger generation does not have the same skills with Russian language and culture as people of my generation." he said.

¶11. (U) A second approach to attracting the next wave of FDI to Estonia focuses not on geography, but on transition within the economy. The president of the American Chamber of Commerce in Tallinn has frequently advised the GOE to increase focus on tourism, services, higher value-added industries, and exports, rather than the import of components and raw materials for processing here. (Comment: This approach might address the shortage of semi- and unskilled labor, but would require a long-term approach to re-tooling the economy. It is not clear that development of such a long term approach is likely within the GOE, which has been characterized by frequent changes of leadership over the past 15 years. End Comment)

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